

BEFORE THE
DEPARTMENT OF TRANSPORTATION
OFFICE OF THE SECRETARY
WASHINGTON, D.C.

TRANSATLANTIC, TRANSPACIFIC, TRANS-
BORDER, AND LATIN AMERICAN SERVICE
MAIL RATES INVESTIGATION

Docket OST-1996-1629

**REPLY OF THE UNITED STATES POSTAL SERVICE TO CARRIERS' ANSWERS
TO ITS MOTION FOR CONVENING OF MEETING
AND CONTINUATION OF CURRENT RATES**

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(December 30, 2003)**

The United States Postal Service hereby replies to the various answers¹ to the Postal Service's Motion for Convening of Meeting and Continuation of Current Rates, filed on December 8, 2003. (Docket OST-1996-1629-307). The Postal Service also moves that the Department grant leave to file this reply. Although not provided for in the Department's rules, the instant pleading will benefit the record by addressing several erroneous statements, implications, and omissions in the carriers' pleadings. Accordingly, the Postal Service urges the Department to accept this reply and give it due consideration in making a determination on the Postal Service's motion.

¹ Answer of American Airlines, Inc. to Motion of United States Postal Service (December 17, 2003) Docket OST-1996-1629-309; Answer of Continental Airlines, Inc. (December 17, 2003) Docket OST-1996-1629-312; Answer of Delta Air Lines, Inc. to Motion of United States Postal Service (December 17, 2003) Docket OST-1996-1629-311; Answer of United Air Lines, Inc. to Motion of United States Postal Service (December 17, 2003) Docket OST-1996-1629-313; Reply of Northwest Airlines, Inc. to Answers to Motion of United States Postal Service; Motion for Leave to File (December 23, 2003) Docket OST-1996-1629-315. Although Northwest's response was denominated a "reply" and was filed subsequently, it was actually a "response" to the Postal Service's motion and not a "reply" to the airlines' answers, as is the instant pleading.

I. The Postal Service Request Was Not Ill-Founded.

According to the carriers, the Postal Service's proposal to examine alternative costing methodologies is an "ill-conceived" (Delta), unsupported (American and Northwest), "one sided" (United) and "radical" (Delta and Continental) proposal that the Postal Service seeks to have the Department "assume" (Continental) through some "shortcut" process (United). Contrary to these claims, the Postal Service's goal is to encourage and support the Department, through the established process, to find a methodology for setting international mail transportation rates that is more consistent with carrier costs and, therefore, better meets the statutory mandate that these rates be fair and reasonable. It is incontrovertible that to set prices, as the Department currently does, based on a fully distributed costing methodology, is not economically sound.² An economically unsound methodology cannot be relied upon to produce fair and reasonable rates. The fact that current market rates for freight are several times less than mail rates indicates that the current methodology results in inequitable mail rates. Therefore, a further change in rates based on the current methodology, however "well established," would not meet the statute's requirement that rates be fair and reasonable.

² Ronald R. Braeutigam, *An Analysis of Fully Distributed Cost Pricing in Regulated Industries*, Rand Journal of Economics, Volume 11, No. 1, Spring 1980. The unfairness of fully distributed costing is easy to illustrate. Suppose a doubling of international passenger transportation and constant mail volume. This would increase the number of flights overseas and therefore increase the costs of fuel, pilots, cabin and ground crews, insurance, landing and ramp fees, and, perhaps, even the number of aircraft in operation (raising capital costs). Using the current pricing methodology, the Postal Service and its customers would pick up a portion of these additional costs, even though they had no part in causing these cost increases. This could lead customers away from the Postal Service and toward its competitors even if the competitors had higher marginal costs. This methodology therefore creates an unlevel playing field in international mail markets given that competitors in this market are free to negotiate with the airlines. Conversely, suppose passenger and freight demand remain constant but mail volume doubles. With pricing based on fully distributed costs, the Postal Service and its customers would pick up only a portion of the cost increase, with the rest paid by passenger and cargo shippers. This is also fundamentally unfair to the airlines, their passengers and other customers, as well as to the competitors of the Postal Service.

The Postal Service believes that the Department ought not to exacerbate this situation and should maintain the current rates until it has an opportunity to fully examine possible alternatives.

In order to clarify the situation further, the Postal Service is filing herewith supporting data which underlie the summary presentations provided to the carriers and the Department last month and filed in this docket as OST-1996-1629-305. These supporting data more than adequately demonstrate that the Department should conclude that using the current methodology to set rates for the next rate period (calendar year 2004) would not result in rates within the "zone of reasonableness." OST-96-1629-279, Order 79-7-17, dated 3 July, 1979, page 5. Doing so would only exacerbate the overcompensation for foreign mail transportation. Indeed, the fact that all seven carriers in the current DOT carrier pool submitted proposed rates for the USPS international air transportation (IAT) solicitations that were below the DOT established rates for the same origin/destination pairs suggests that they can still make a sufficient profit at the lower rates. Rates for the eleven most recent IAT contract awards are not included in the supporting documents because the carriers requested confidentiality of proprietary information and non-disclosure. However, the Postal Service analysis reveals the following comparison of the weighted average rates per pound for all regions combined: DOT rate is \$1.53 per pound, freight rate is \$0.53 per pound, negotiated contract rate is \$0.73 per pound, and an incremental cost method is \$0.24 per pound.

For these reasons, the Postal Service believes that the current rates (and the methodology by which they are calculated) can no longer be supported by the

Department. Therefore, the Postal Service's motion to maintain the current rates until further order is legitimate and a Show Cause order to that effect is appropriate. In addition to the Show Cause process, the air carriers and the Postal Service can request that the rates be changed at other times, and could request that the formula be changed, and the Secretary of Transportation could do so on his own initiative.

II. The Department Has the Authority to Grant the Postal Service's Requests

The Postal Service's motion did not prescribe alternative reasonable rates because it was its stated intent to continue its dialog in an effort to reach a consensus with the Department and the carriers on other options. If no agreement can be reached, the Department has the authority to make whatever rates it finally establishes retroactive to January 1, 2004. Similarly, initial rates for calendar year 2003 were established on an interim, retroactively adjustable basis by Order 2002-12-23. The Postal Service requests the Department to provide for similar action at this time: (1) a reasonable time period for discussion and analysis of alternative methodologies prior to establishing final rates; and (2) consideration of the potential harm any further rate increase would cause the Postal Service and the Department of Defense.

Delta argues that the Administrative Procedure Act requires a full opportunity for notice and comment before the actions urged by the Postal Service can be adopted. Delta Answer at 1. However, the Postal Service is not asking the Department to unilaterally change its methodology without a full opportunity for notice and comment. As stated above, the Postal Service is simply asking the Department to defer a rate change until possible alternatives are fully explored and can be adopted. The

Department certainly has the discretion to defer action temporarily without the need for administrative procedures, as it did for calendar year 2003. Order 2002-12-23.

Continental argues that the Postal Service is seeking to use methodologies that were “rejected” by the DOT in the past. Continental Answer at 2. In fact, the Department’s predecessor specifically endorsed marginal costing, but was unable to apply it due to lack of data. Order 78-11-80, at 23 (November 16, 1978).

The carriers argue that the Postal Service’s motion is either “unsupported” or is based only on a “conclusory” or “incomplete” analysis. The analysis previously provided and supplemented herewith is as thorough as possible given the data available in the public domain. Moreover, there is no question that any intellectually honest and reasonable substitute methodology will result in lower mail rates. Thus, the requested deferral of any rate increase is justified as a temporary measure, pending the requested meeting and future proceedings.

III. Economic Conditions Do Not Support the Status Quo

Both American and Continental argue that the assumed rate increase must occur because of adverse economic conditions facing the airline industry. This argument ignores the fact that the Postal Service faces similar conditions and that the carriers’ financial condition is a concern to the Postal Service as well. Not only must the Postal Service deal with its own economic problems, but cutbacks in commercial air service have had an effect on its ability to meet mail service commitments. While Continental is concerned about being under-compensated, the Postal Service believes the Department must not continue to over-compensate the carriers. That is why the Postal Service requested a “freeze” of the current rates instead of a rate reduction, even

though the Postal Service maintains, and the supporting documentation shows, that the current rates are excessive.

In addition to the economic conditions that affect every American industry and the effects of September 11th, the Postal Service suffered the anthrax attacks and is facing declining letter mail volume from electronic diversion. The Postal Service is taking the necessary steps to address these conditions. President Bush accepted a number of postal reform recommendations from the President's Commission on the Postal Service. Among those was the need to increase flexibility for controlling costs. Short of total deregulation, greater authority to negotiate rates for the international air transportation of mail or simply substituting more appropriate costing methodologies falls within the scope of those findings. In any event, it is not the Postal Service's responsibility to alleviate economic conditions or to offset the carriers' weak performance, whatever its origin.

IV. The Discussion Process Held and Suggested Is Appropriate

United states that the Postal Service's motion was preceded by *ex parte* discussions at a meeting between the Postal Service and DOT. United Response at 2. While United does not directly allege any impropriety, and perhaps none is implied, it should be noted that the information presented to DOT had been presented to representatives of United and the other major carriers the week before. Furthermore, the discussions between the Postal Service and DOT took place based on the Postal Service's commitment to DOT to make the fact of the meeting and the material presented at it publicly available. The Postal Service did so on December 1, 2003. OST-1996-1629-305.

United erects another straw man when it argues that “the suggestion that DOT simply be a bystander while the Postal Service chairs such a meeting or undertakes an informal procedure to establish international mail rates – a process clearly impermissible under the statute and not available under any circumstances for letter class mail – is without merit.” United Answer at 5. The Postal Service never intended to meet without DOT’s participation and oversight. The Postal Service simply offered to host the meeting and chair a working group. There is no basis for United’s allegation that discussions would somehow not be conducted under the authority of DOT. The Postal Service clearly understands that any such meetings or procedures would be under the auspices of the Department and does not seek to make the DOT a “bystander,” a frivolous allegation, given the Department’s unilateral authority regarding these rates. In fact, during the discussions held with the carriers, the Postal Service acknowledged that any meeting concerning this docket would have to be under the auspices of the Department.

The Postal Service does believe that the Department can, if it chooses, legitimately delegate authority to host and conduct informal discussions, which is all the Postal Service requested. The Postal Rate Commission, for instance, routinely delegates Postal Service counsel as “settlement coordinator” to arrange and conduct informal discussions among interested parties for the purposes of resolving issues informally.³ The results of such discussions and any negotiated settlement are then

³ Docket No. R2001-1: Tr. 1/41 and PRC Op. at 4 (March 22, 2002); Docket No. MC2003-2: Order No. 1373, at 10 (June 3, 2003); Docket No. MC2003-1: Order No. 1365, at 8 (March 19, 2003); Docket No. MC2002-3: Order No. 1347, at 6, 8 (October 2, 2002); Docket Nos. MC99-1 and MC99-2: Order No. 1233, at 11 (March 16, 1999) and PRC Op. at 5 (May 14, 1999).

presented to the Commission for its independent consideration. The Commission retains its full authority and may adopt all, part or none of the settlement, as it sees fit according to its statutory duties, following independent review of the record and the settlement. PRC Op., R2001-1, at 17-24 (March 22, 2002); *see, e.g.*, PRC Op., MC99-1, at 15-16 (May 14, 1998); There is no usurpation of the Commission's authority. The Postal Service sees no bar to DOT's acting similarly.

V. Marginal Costing Is Indeed the Basis of Postal Ratemaking

Both American and Delta allege that the Postal Service is seeking to impose marginal costing upon this process, contrary to what is required for setting domestic rates of postage. Delta Answer at 3; American Answer at 3-4. Interestingly, both carriers cite 39 U.S.C. § 3226. However, there is no section 3226 in title 39.

The relevant ratemaking criteria are set forth in section 3622. Contrary to the carriers' unfounded assertions, section 3622, the Supreme Court's interpretation thereof, and longstanding Postal Rate Commission's practice permit and promote ratemaking based on marginal costing. Section 3622(b) requires that rates be set so that each class of mail bears its direct and indirect attributable costs, and recovers an appropriate portion of all other costs of the Postal Service, with those other costs judgmentally assigned on the basis of eight other factors enumerated in that section. 39 U.S.C. § 3622(b). The phrase "direct and indirect attributable costs" is interpreted to refer to marginal costs ("volume variable" costs, as well as "product specific" costs). Only these costs are allocated to the classes of mail based on the appropriate functional distribution keys, such as pound-miles. Other costs, which neither vary directly with the volume of mail nor relate specifically to a particular mail service, are not allocated

mathematically in the same proportions, as with fully distributed costing. Instead they are allocated on the basis of the factors judged relevant. This allows each type of mail service to bear an appropriate share of “overhead” costs, rather than assume those costs should be allocated based on that service’s share of marginal costs.

Moreover, the Postal Rate Commission specifically *rejected* fully distributed costing soon after the Commission was established to set postal rates:

In the prior case, we expressed statutory reservations regarding a fully distributed costing method under which costs are first assigned to the classes and services on the basis of causation, and the remaining mathematically apportioned on a uniform basis. See PRC Op. [R71-1], i-280, n. 1. We now believe those reservations were well taken; and that fully distributed costs, as defined above, would not satisfy the standards of § 3622. We reject a fully distributed costing method here in favor of the concepts of variability and demand discussed throughout this opinion.

PRC Op., R74-1 at 124, n. 3 (August 28, 1975).⁴

VI. The Carriers’ Various Substantive Claims Are Unfounded

The carriers make various substantive arguments concerning the analysis summarized in the document filed in OST-1996-1629-305. Although the Postal Service believes that these issues are best dealt with in the context of further meetings and discussions, we will preliminarily address some of the issues raised to assist the Department in dismissing any concern it might have in these regards.

⁴ The Supreme Court eventually affirmed this approach, reversing a Court of Appeals decision that required the Commission to use “cost accounting principles” to apportion “costs on the basis of ‘distribution keys,’ such as weight or cubic volume of mail, notwithstanding the lack of proof that such factors play a causative role.” *National Association of Greeting Card Publishers v. United States Postal Service*, 462 U.S. 810, 816-17 (1983). The Court noted that “[s]uch accounting principles are used in utility ratemaking proceedings that employ ‘fully allocated costing’ systems. ... The Post Office utilized such a system prior to the [Postal Reorganization] Act.” 462 U.S. 817 n. 7.

American stated that the analysis does not focus on specific markets. American Answer at 2. This is incorrect. Not only did our motion so state at p. 2, but this fact that specific markets were analyzed was raised in Postal Service discussions with the air carriers and the Department. The additional supporting documentation submitted with this response should remove any remaining doubt. See pages 87-90. The documentation should also show the unfounded and confrontational nature of American's allegation that the calculation of a Postal Service overpayment of \$233 million was "a loosely contrived and unsupported provocative statement." American Answer at 3. United in its response states, in part, that the analysis is "fundamentally flawed." United was passing judgment based on an executive summary without having seen the fundamental supporting documentation now provided.

American expresses disagreement with using summary data for the load factor analysis. American Answer at 2. Although only the summary data was contained in the report, a monthly lane-based granular analysis was used to build the summary data. Load factor analysis was used to illustrate available capacity on the system, demonstrating that mail is not displacing freight. On the rare occasion that freight is bumped, the mail rate far and away exceeds the average freight rates paid to the carriers. Mail demand is an extremely small percentage of the available network capacity regardless of weight restrictions, seasonality, and time frames.

American also argues that the Postal Service has assumed that carriers do not invest in capital assets to support bellyhold products. American Answer at 2. The Postal Service acknowledges the investments made by the combination carriers associated with mail products. However, the carriers' core business is the

transportation of passengers and their baggage. Mail is a secondary business to passenger carriers. Carriers would not enter a new route, purchase a new aircraft, hire additional pilots nor incur more cycle driven maintenance expense solely to transport mail products representing less than two percent of annual revenues.

United states that the Postal Service is its single largest customer, that it has substantial investments in the infrastructure required to support the Postal Service, and that mail is an integral part of its overall operation. United Answer at 3. The fact is that United Cargo generated \$673M in revenue for 2002 (including both mail and freight). United's 2002 annual report (page 5) states, "Freight accounts for most of United Cargo's shipments, while mail remains an important component of United's cargo strategy." A compilation of Form 41 data for the passenger carriers reveals that mail accounts for less than one percent of total operating revenue (for United it is 1.16%) and, therefore can hardly be considered "central."

United then alleges that the Postal Service lacks adequate mail management systems and that this is the cause of under-utilized belly capacity. United Answer at 4-5. Excess belly capacity is a function of aircraft design, passenger behavior, shipper behavior, and industry conditions. U.S. origin international mail traffic moves counter to the dominant direction of freight flow in all regions except a few Latin America routes.

United also argues that the Postal Service's analysis does not consider the effects of varying demand by market, day of the week, or seasonality. United Answer at 5. This argument presupposes that the confluence of factors (seasonality, day of week, etc.) works only to the detriment of the carriers. The analysis was performed using the most conservative estimates and fact-based methodologies that could be defended.

Monthly T-100 data was used in the analysis to get a seasonal variation. Granular lane-by-lane analysis was used to build summary tables. Every minor element (e.g., personnel screening – which is about 0.1 cents per pound) was considered in the analysis to ensure the analysis was fair and reasonable in compensating the carriers for all possible cost items. This approach is definitely not “one-sided.”

Delta argues that boarding priority is clearly worth more than the marginal cost of empty belly space. Delta Answer at 2. The issue of boarding priority is only a valid concern when the potential exists for mail to bump freight due to capacity limitations. As previously stated, U.S. origin international mail traffic moves counter to the dominant direction of freight flow in all regions except a few Latin America routes. The enormous amount of unused capacity on most routes does not justify a threefold premium for boarding priority. The Postal Service does not erroneously assume there is always empty belly space. In fact, the Postal Service acknowledges that certain carrier segments are fully utilized some of the time. The Postal Service’s conclusions were based on global conditions. Similarly, DOT rates are established for four geographic regions.

Delta argues that it and other carriers offer space available freight products with rates at or above the DOT mail rate with a lower boarding priority. Delta Answer at 2. Data shows that this scenario rarely occurs and the vast majority of freight products (and almost all freight weight) is priced well below the DOT mail rate. The issue of boarding priority is only a valid concern when the potential exists for mail to bump freight due to capacity limitations.

Delta also argues that the carriers must invest in additional infrastructure and employees to handle Postal Service requirements. Delta Answer at 3. Handling cost is indeed included in the Postal Service's analysis. However, the extent that infrastructure is a causative factor for international mail transportation is debatable, given the fact that the carriers may use the same resources for domestic mail and freight as well as for their passenger business.

CONCLUSION

Notwithstanding the carriers' protestations, the Postal Service is not alone in its belief that the shift toward using marginal costs is appropriate. Neither is it alone in believing that the carriers' arguments to the contrary have no real merit. The Department's predecessor thought so as well. CAB Order # 78-11-80, at 22-23. As far back as 1978, the Civil Aeronautics Board stated:

As set forth in numerous economic treatises, regulatory opinions and judicial decisions, *the purpose and function of marginal cost ratemaking is to replicate, as closely as possible, the pricing and resource allocation functions of a competitive marketplace.* The courts increasingly have recognized that *there is no legal or economic necessity to use fully allocated or fully distributed costs in the determination of "just and reasonable" or "fair and reasonable" rates.* [Footnote omitted.] Among other things, a factual-based marginal cost analysis permits a much more accurate picture of what joint product rates ought to be, and eliminates much of the rough judgment that goes into determining capacity causation. Although we have not, because of the limitations of this record, applied a marginal cost analysis to domestic mail rates here, we have been guided to some extent by marginal cost principles. *We are more than a little troubled by the possibility that the rates we set here are too high* from the standpoint of efficient pricing, given the extent of the excess capacity in aircraft bellies apparent on this record. For the future, we intend to explore procedural and analytical methods which will facilitate the establishment of mail rates on a marginal cost basis, where reasonable, either through regulatory proceedings or through the

operation of the competitive marketplace itself....goals, which we are convinced are fully consistent with our legislative mandate.

CAB Order # 78-11-80, at 23 (emphasis added).

Effectuation of the Board's intention is long overdue. This situation should not be allowed to continue. Deferring the expected 2004 rate increase is a small, but necessary, step toward remedying this situation and restoring equity and fairness to international mail transportation rates. Nothing the carriers have said in their answers should dissuade the Department from taking the first, small step.

As to the timing of the meeting, United submits that "it should be scheduled for no sooner than March 2004, with ample notice provided." United Answer at 6. Although the Postal Service's motion did not specify a particular date, at this time the Postal Service believes the middle of the second week of February 2004 to be appropriate. This date allows sufficient time for review of the supporting data submitted herewith (most of which has been publicly available for some time) and is slightly longer than the usual time frame for responses to Show Cause orders. It also takes travel time into consideration. The longer resolution of this issue is prolonged, the more the Postal Service believes it will suffer further harm from the inflated rates already in existence. Additionally, the Secretary of Transportation has an obligation to "act expeditiously on proposed changes in prices". 49 U.S.C. § 41907(b). Contrary to Northwest's opinion that the carriers will be penalized by imposing a freeze (Northwest Reply at 2), the Postal Service maintains that it, and not the carriers, is the party that is harmed by the current rates and the methodology by which they are established.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person listed below by First-Class Mail, and by email where such addresses are listed.

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